

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

CITIZENS UTILITY BOARD)

Request for an investigation)

into the current structure of the Nicor)

Customers Sect Pilot Program and the)

Proposed Changes filed August 10, 2000,)

Meet the Public Interest Standards and)

Other Requirements Set Forth in the)

Public Utilities Act. 220 ILCS 5/4-101;)

220 ILCS 5/8-101; 220 ILCS 8-102)

Docket No. 00-0620

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ILLINOIS
COMMERCE COMMISSION

REBUTTAL TESTIMONY

OF

JEROME D. MIERZWA

ON BEHALF OF THE

ON BEHALF OF

CITIZENS UTILITY BOARD

COOK COUNTY, and

PEOPLE OF THE STATE OF ILLINOIS

(GOVERNMENTAL AND CONSUMER INTERVENORS; "GCI")
GCI EX 3.0 NP

NON-PROPRIETARY
(Exhibits have been omitted only)

FEBRUARY 7, 2001

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I. INTRODUCTION

Q. WOULD YOU PLEASE STATE YOUR NAME AND BUSINESS ADDRESS?

A. My name is Jerome D. Mierzwa. I am a principal and Vice President with Exeter Associates, Inc. My business address is 12510 Prosperity Drive, Suite 350, Silver Spring, Maryland, 20904. Exeter specializes in providing public utility-related consulting services.

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING?

A. Yes. My direct testimony was submitted as GCI Exhibit 2.0.

Q. WHAT IS THE PURPOSE OF YOUR RREBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to the rebuttal testimonies of Nicor Gas witnesses Mr. Albert E. Harms and Mr. Leonard M. Gilmore.

II. WITNESS: HARMS

Q. WITNESS HARMS CLAIMS THAT THE COMPANY'S PROPOSED *CUSTOMER SELECT* CHARGES AND FEES ARE NOT A BARRIER TO ENTRY AND THAT THE TAX SAVINGS ADVANTAGE REALIZED BY SUPPLIERS EXCEEDS THE AMOUNT OF THE CHARGES AND FEES. HOW DO YOU RESPOND TO WITNESS HARMS?

A. Witness Harms' claim and analysis are misleading and incomplete. Witness Harms claims that 26 suppliers have elected to participate in *Customer Select*. However, this measure is not a reasonable indicator of supplier interest in serving residential customers, which is the primary focus of this proceeding. Many of the 26 participating suppliers are

interested in serving larger commercial and industrial customers exclusively. As explained in my direct testimony, only three current suppliers intend to continue to market to residential customers.

The claim that suppliers serving *Customer Select* customers enjoy a tax savings cost advantage fails to consider a number of relevant structural cost advantages enjoyed by Nicor Gas. The tax savings for suppliers results from the avoidance of certain state and municipal taxes on the gas sold to *Customer Select* participants. These taxes, which average 7.2 percent for a typical residential heating customers, are assessed on the rates for gas supply service to retail sales customers, but are not assessed on the rates for gas supply service to *Customer Select* participants. Mr. Harm's claim of a tax advantage for suppliers fails to consider that suppliers are required to recover their property taxes, state and federal income taxes, marketing, operating and other expenses in their rates for gas supply service. Nicor Gas collects these expenses through its rates for distribution service. This provides Nicor Gas with a significant competitive advantage. It is unreasonable, at best, for Nicor Gas to base and support its *Customer Select* charges and fees on an incomplete and one-sided consideration of selected taxes paid by itself and competitive suppliers.

- Q. WITNESS HARMS IMPLIES THAT A HEALTHY AND VIBRANT COMPETITIVE ATMOSPHERE FOR NATURAL GAS SERVICE ON THE NICOR GAS SYSTEM ALREADY EXISTS. DO YOU AGREE?
- A. Partially. It appears that such an atmosphere exists for larger commercial and industrial customers. However, competition for service to residential customers currently consists

of three suppliers with one supplier serving nearly all residential customers. This cannot be considered a healthy and vibrant competitive atmosphere. Competition for service to small commercial customers may also be limited.

Q. WITNESS HARMS APPEARS TO DISAGREE WITH THE NOTION THAT SUPPLIERS SERVING CUSTOMERS IN *CUSTOMER SELECT* OPERATE ON NARROW PROFIT MARGINS. ON WHAT DO YOU BASE YOUR CONCLUSION THAT SUPPLIERS SERVING CUSTOMERS IN PROGRAMS SUCH AS *CUSTOMER SELECT* OPERATE ON NARROW PROFIT MARGINS?

A. My discussions with suppliers in this and other proceedings and industry publications confirm that suppliers operate on narrow profit margins. For example, the National Regulatory Research Institute report Household Participation in Gas Customer Choice Programs: Some Facts, Explanations, and Lessons Learned, states:

A recent industry survey calculated that the cost of pursuing and signing one residential gas customer by a marketer is around \$200, while the margin for that customer would average only \$25 per year. This translates into an eight-year payback period, which would discourage most marketers from entering the residential market. When, for example, a new entrant attempts to penetrate a new market it may be willing to take a loss during initial periods. Later, in a more mature market, it can earn profits as the market sorts itself out. Marketers unwilling to take losses may be reluctant to enter a new market because of thin profits and inadequate sales potential partly caused by customer confusion about choice (Footnotes omitted).

Nicor Gas was provided this report in response to data request CUB-2.

- Q. WITNESS HARMS BELIEVES THAT THE \$10 CHARGE ASSESSED TO SUPPLIERS FOR EACH CUSTOMER THE SUPPLIER ACQUIRES FROM ANOTHER SUPPLIER (SWITCHING FEE) IS NOT A DETERRENT TO COMPETITION. DO YOU AGREE?
- A. No. Again, witness Harms' position is consistent with his belief that suppliers do not operate on small profit margins. As previously explained, this assumption is wrong. If a supplier's profit margin is on the order of \$25 per year, as previously suggested, the \$10 switching fee is certainly a deterrent. Of course, the \$10 switching fee currently benefits Nicor's affiliate, Nicor Energy, in that it deters suppliers from competing for the customers already acquired by Nicor Energy. In addition, if Nicor Energy acquires a customer from another supplier, the \$10 switching fee is not a deterrent for Nicor Energy since the fee stays "All In The Family."
- Q. WITNESS HARMS CLAIMS THAT THE FACT THAT THE COMPANY HAS ADDED SUPPLIERS TO THE *CUSTOMER SELECT* PROGRAM EACH YEAR IS AN INDICATION THAT THE SWITCHING FEE HAS NOT HINDERED COMPETITION. DO YOU AGREE?
- A. No. While supplier participation may have increased over the years for larger commercial and industrial customers that has not been the experience for suppliers serving low margin residential and small commercial customers.

Q. WITNESS HARMS BELIEVES THAT THE COMPANY'S BILLING POLICY OF PROHIBITING SUPPLIERS FROM ISSUING A SINGLE BILL FOR BOTH GAS SUPPLY AND DISTRIBUTION CHARGES DOES NOT HINDER COMPETITION. DO YOU HAVE ANY OBSERVATIONS?

A. Yes. Witness Harms is well aware, from Company meetings with various suppliers, that suppliers want the ability to issue a single bill and that customers want to be issued a single bill. Prohibiting suppliers from offering customers their preferred billing option necessarily hinders competition. Suppliers would not be interested in rendering a single bill for gas supply and distribution charges if doing so did not enhance their ability to compete.

Q. WITNESS HARMS BELIEVES THAT YOUR RECOMMENDATION TO ELIMINATE THE PROPOSED *CUSTOMER SELECT* CHARGES AND FEES IS CONTRARY TO THE COMMISSION'S LONGSTANDING POLICY OF ELIMINATING SUBSIDIES. DO YOU HAVE ANY COMMENTS?

A. Yes. As I explained in my direct testimony, Nicor Gas' distribution charges, which are paid by *Customer Select* participants, include costs for expenses no longer incurred by Nicor Gas on behalf of these customers. Such costs would include the carrying charges associated with gas in storage inventory. Including such costs in the rates for distribution service to *Customer Select* participants would also be considered a subsidy paid by these customers and violate witness Harms' theory. The Commission should reject witness Harms' selective use of the "subsidy argument."

Q. WITNESS HARMS CLAIMS THAT NICOR GAS IS NOT COMPETING TO KEEP CUSTOMERS AND, IF IT WAS, IT WOULD NOT BE OFFERING CUSTOMERS A CHOICE OF SUPPLIERS. DO YOU HAVE ANY COMMENTS?

A. Mr. Harms' belief about whether Nicor Gas is competing to keep customers on system supplies is irrelevant. As suppliers consider the costs they will incur and the prices they will have to charge to recover those costs, Nicor Gas' charges and fees certainly provide the Company a competitive edge in providing natural gas supply service. In addition, whether actively competing or not, natural gas supply service from Nicor Gas continues to be an alternative, and as the incumbent supplier, Nicor Gas enjoys an advantage over other suppliers.

Q. WITNESS HARMS CLAIMS THAT NONE OF ITS *CUSTOMER SELECT* CHARGES AND FEES ARE IN EXCESS OF INCREMENTAL COSTS. DO YOU HAVE ANY COMMENTS?

A. Yes. Any calculation of the incremental costs associated with the *Customer Select* program must consider both cost increases as well as cost decreases. Nicor Gas has failed to give any consideration to incremental cost decreases such as reduced storage inventory carrying charges.

Q. WITNESS HARMS BELIEVES THAT ANY COST SAVINGS TO THE COMPANY ASSOCIATED WITH *CUSTOMER SELECT* SHOULD BE EVALUATED AND REFLECTED IN RATES AT THE TIME OF A BASE RATE PROCEEDING. DO YOU HAVE ANY COMMENTS?

A. Yes. Witness Harms' position is internally inconsistent. Under witness Harms' theory, rates can be adjusted to reflect increased costs outside of a base rate proceeding, but cannot be adjusted to reflect cost decreases outside of a base rate proceeding. It is inconsistent with traditional ratemaking procedures to consider only increases in costs associated with the *Customer Select* program and increase rates to recover those costs without also considering any cost decreases associated with the program.

Q. WITNESS HARMS CLAIMS THAT THE COST SAVINGS ASSOCIATED WITH THE REDUCTION IN STORAGE INVENTORY CARRYING CHARGES DO NOT EXCEED THE ADDITIONAL REVENUES COLLECTED THROUGH THE VARIOUS *CUSTOMER SELECT* CHARGES AND FEES. DO YOU AGREE WITH THIS ANALYSIS?

A. No. Witness Harms' analysis is based on outdated data from 1996. Nicor Gas' current base rates are deemed adequate to recover current costs until the Commission finds otherwise and approves a change in base rates consistent with a review of all costs of providing service. Therefore, the impact of the *Customer Select* program on Nicor Gas' current storage inventory carrying charges should serve as the basis for calculating the savings experienced by Nicor Gas.

Under the *Customer Select* program, a supplier serving a residential heating customer is assigned storage capacity equal to 26 times the customer's maximum daily use. The maximum daily use of an average residential heating customer is 17 therms and, thus, the supplier would be assigned 442 therms of storage capacity. In addition, a supplier is assigned storage capacity for balancing purposes equal to 6 times each

customer's maximum daily use, or 102 therms. Therefore, in total, a supplier serving a residential heating customer is assigned 544 therms (442 therms plus 102 therms) of storage capacity.

Nicor Gas determines how storage is to be utilized by suppliers under the *Customer Select* program. It is reasonable to assume that Nicor Gas will direct suppliers to use storage in a fashion similar to that used by Nicor Gas to provide sales service. In 2000, on average, Nicor Gas maintained storage inventory at 60 percent of maximum capacity. Assuming Nicor Gas' current storage carrying charge factor is comparable to that in its last base rate proceeding of 16 percent, at a 40 cents per therm cost of gas, Nicor Gas' storage inventory charges would decrease by \$1.74 per month when an average residential heating customer switches to *Customer Select*. This reduction in costs is greater than the \$1.06 per month in additional costs per customer, which Nicor Gas claims that it incurs under *Customer Select*.

Q. WITNESS HARMS CONTENDS THAT YOUR CLAIM THAT THE SAVINGS TO BE EXPERIENCED BY NICOR GAS IN STORAGE INVENTORY CARRYING CHARGES IS A "SINGLE ISSUE" RATEMAKING ITEM. IS THIS A FAIR CRITICISM?

A. No. A utility's rates are set to recover its cost of service that consists of a number of costs items. "Single issue" ratemaking refers to adjusting a utility's rates to reflect a change in one cost item without considering changes in all other cost items. Witness Harms claims that my recommendation to eliminate the proposed *Customer Select* charges and fees because the Company's storage inventory costs have declined is single-

issue ratemaking. Nicor Gas' proposal to recover the costs associated with its *Customer Select* program through the proposed charges and fees without considering changes in all other cost items is single issue ratemaking. Even witness Harms appears to concede that the failure to consider changes in all cost items when establishing rates is inappropriate.

Q. IS IT YOUR POSITION THAT THE *CUSTOMER SELECT* PROGRAM DOES NOT PROVIDE MEANINGFUL CHOICE FOR RESIDENTIAL CUSTOMERS AS WITNESS HARMS CLAIMS?

A. Yes. For choice to be meaningful, there must be a full range of suppliers from which residential customers may choose. Currently, in fact, the number of suppliers from which smaller customers may choose is extremely limited.

Q. IS IT YOUR POSITION THAT WITH ONE SUPPLIER DOMINATING THE MARKET, THERE IS NO COMPETITION, AS WITNESS HARMS CLAIMS?

A. No. The focus of this proceeding is not whether the residential and small commercial customers of Nicor Gas have more than one supplier from which to purchase their natural gas service. The focus of this proceeding is whether residential and small commercial customers have a meaningful choice of suppliers. Consumer welfare is maximized when choice is meaningful. For there to be meaningful choice, there must be in place a market structure that allows each customer to have a full range of suppliers from which to choose. For this to occur, there must be at least workable competition.

The *Customer Select* program provides the affiliate of Nicor Gas, Nicor Energy, with competitive advantages and, therefore, hinders the development of competition and

meaningful choice by making it more difficult for suppliers to compete. As explained by witness Alexander, Nicor Gas' consumer education program is insufficient, making it more difficult for customers to make informed choices. As a result, Nicor Energy currently dominates the market and there are a limited number of suppliers from which *Customer Select* participants may choose. Therefore, it is my position that workable competition does not exist for the residential and small commercial customers of Nicor Gas.

Q. WITNESS HARMS CLAIMS THAT YOU HAVE FAILED TO PROVIDE ANY EVIDENCE, NOR DOES ANY SUCH EVIDENCE EXIST, THAT THE COMPANY HAS VIOLATED ITS OWN STANDARDS OF CONDUCT. ON WHAT EVIDENCE DO YOU BASE YOUR CLAIM?

A. I provided Nicor Gas the basis for my claim in response to data request JDM-21, which states as follows:

JDM 21 With reference to page 16, line 17, please specifically itemize which activities purportedly violate which of the Company's Standards of Conduct. Provide all supporting documentation.

Response

Page 4 of the document entitled "Customer Select and Market Competition" from the response to CUB 2.22(GCI Ex. 3.1) explains that under Nicor's Standards of Conduct, all suppliers are treated equally. It is Mr. Mierzwa's understanding that non-affiliated suppliers do not have access to Nicor personnel as Nicor Energy does. Therefore, all suppliers are not treated equally. See the responses to CUB 1.40(GCI Ex. 3.2) and CUB 2.8(GCI Ex. 3.3).

The discovery responses identified in my response are attached to my rebuttal testimony and reveal that a number of Nicor Gas employees were hired by Nicor Energy and that a number of Nicor Gas employees worked for Nicor Energy, contributing to Nicor Energy's success in the *Customer Select* program. Nicor Gas did not similarly offer to assist Nicor Energy's competitors and, therefore, all suppliers were not treated equally, violating the intended purpose of the Company's Standards of Conduct.

Q. WITNESS HARMS CLAIMS THAT NICOR ENERGY RECEIVED NO PREFERENTIAL TREATMENT FROM THE TRANSFER OF EIGHT EMPLOYEES TO NICOR ENERGY, L.L.C. DO YOU HAVE ANY COMMENTS?

A. Yes. Nicor Energy's ability to attract Nicor Gas employees is greater than that of other suppliers. By accepting a position with Nicor Energy rather than another supplier, a Nicor Gas employee may avoid certain unpleasant aspects of accepting a new position such as relocation and the loss of certain pension and other employee benefits. Moreover, labor market costs associated with finding, selecting and hiring new employees are avoided by Nicor Energy when utility employees are transferred to the affiliate.

Q. WITNESS HARMS DISAGREES WITH THE IMPLICATION OF THE VARIOUS GCI WITNESSES THAT *CUSTOMER SELECT* WAS STRUCTURED TO MOVE GAS SALES FROM NICOR GAS TO NICOR ENERGY AND TO BENEFIT SHAREHOLDERS. DO YOU HAVE ANY COMMENTS?

- A. Yes. Under the *Customer Select* program, gas sales have moved from Nicor Gas to Nicor Energy. Certainly Nicor Energy elected to participate in *Customer Select* with the goal of attracting customers. That is, it was the goal of Nicor Energy to keep the customers of Nicor Gas in the Nicor, Inc. family. Nicor Energy has been successful in achieving this goal. Nicor Energy would not have elected to participate in *Customer Select* unless its shareholder, Nicor, Inc., would benefit from its participation.

III. WITNESS: GILMORE

- Q. WITNESS GILMORE ASSERTS YOU ARE INCORRECT THAT SUPPLIERS ARE NOT ENTITLED TO USE THE STORAGE INJECTION AND WITHDRAWAL FLEXIBILITY FOR WHICH THEIR CUSTOMERS PAY. IS HE CORRECT?
- A. No. As witness Gilmore explains, suppliers have a daily delivery range that may be as much as 15 percent, plus or minus, of the Required Daily Delivery quantity. He further claims that this flexibility is storage. As such he claims that storage flexibility is made available to suppliers. While Mr. Gilmore's understanding of Nicor's tariff is consistent with my understanding, this level of flexibility is significantly less than the flexibility available to Nicor with respect to storage. Nicor maintains significantly more storage flexibility than is made available to suppliers. Nicor may use storage to meet anywhere from 0 to more than 70 percent of its customers requirements. Moreover, limiting the flexibility of suppliers makes it more difficult for suppliers to manage their costs, which is essential to their success.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes. It does at this time